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Agenda Item 6b, May 15, 2006
Attachment 2

March 13, 2006

AGENDA ITEM 9a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Currency Strategic Plan

II. PROGRAM: Currency Overlay

III. RECOMMENDATION: Information Only

IV. ANALYSIS:

Background:

- In 1991, Bill Sharpe and Wilshire were involved in the initial study of what portion of international assets (hedge ratio) should be hedged for CalPERS' international portfolio. Using different methodology, Bill Sharpe and Wilshire came to a similar conclusion that the hedge ratio should be static and approximately 25% over international equity.
- Equity and fixed income were the only two international assets in CalPERS' portfolio in 1992.
- It was then believed that equity managers, unlike fixed income managers, tended to focus on micro rather than macro economic issues, hence equity managers did not have the skill set to manage currency. Therefore, only CalPERS' international equity investments would be hedged.
- Guidelines for the currency overlay program (the program) determined that the primary objective is to provide risk control, or a reduction in the volatility of the returns from the CalPERS' international equity investments while return was given a secondary consideration.
- On November 13, 2000, approval was granted by the Investment Committee (IC) to proceed with a passive currency overlay strategy to be managed internally by CalPERS staff. It was anticipated that staff would gain greater insight into currency overlay program as a whole.

- At the October 28, 2004 Asset/Liability Management Workshop staff presented a primer on the currency overlay program. Staff committed to bring forward considerations for the evolution of the program.
- For the December 13, 2004 meeting, staff presented an information agenda item with three new ideas to enhance the program and solicit feedback.
- The IC gave staff the ability to manage the hedge ratio tactically within bounds of +/- 5% of the targeted hedge ratio of 25% at the April 18, 2005 meeting.
- As of January 31, 2006 the size of the currency overlay program (the Program) was approximately \$10.7 billion.

Attached is the CalPERS Currency Vision for the future (Attachment 1). The presentation:

- Outlines plans
- Considers currency's role in a portfolio
- Reviews CalPERS currency experience
- Provides an overview of active currency strategies

The critical content of the presentation are the following:

1. CalPERS has had a successful currency program
2. Existing programs should remain unchanged
3. That staff is working toward an internal active currency alpha program
4. Currency risk should be considered at the overall CalPERS portfolio level which will be presented at the 2007 Asset Allocation Workshop
5. Staff will continue to inform and work with Wilshire on all aspects of the currency program.

V. STRATEGIC PLAN:

Monitoring and review of the Currency Overlay Program is consistent with CalPERS Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Costs associated with CalPERS currency overlay program are the external manager fees, staff salaries and support systems. The changes envisioned are suggested to improve the cost effective return on CalPERS portfolio.

Eric Busay
Portfolio Manager

Curtis D. Ishii
Senior Investment Officer

Anne Stausboll
Interim Chief Investment Officer

CalPERS Currency Strategy

Building on Capabilities

Agenda

- Outline of plans
- Currency's role in a portfolio
- Review of CalPERS currency experience
- Active currency strategies in the market
- Proposed plan
- Next Steps and Conclusion

Outline

All existing programs and goals to remain unchanged

Those programs are:

1. Currency Overlay Program with a primary goal to reduce risk and add alpha where possible
2. The Internal Passive portfolio

Outline – What is being considered

In the near future

- Active alpha currency program, as a stand alone, run internally, subject to Board approval

In 2007

- Currency risk reduction to be considered at the overall CalPERS portfolio level, rather than asset by asset as it is presently

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Currency's role in a Portfolio

In its most simple form....

Currency policy should either seek

- 1) To reduce portfolio **risk** or
- 2) To increase portfolio **return**

Currency's Role in a Portfolio

- Diversification
- Reduction of portfolio volatility
- Alpha: multitude of empirical evidence show that *it exists*

Agenda

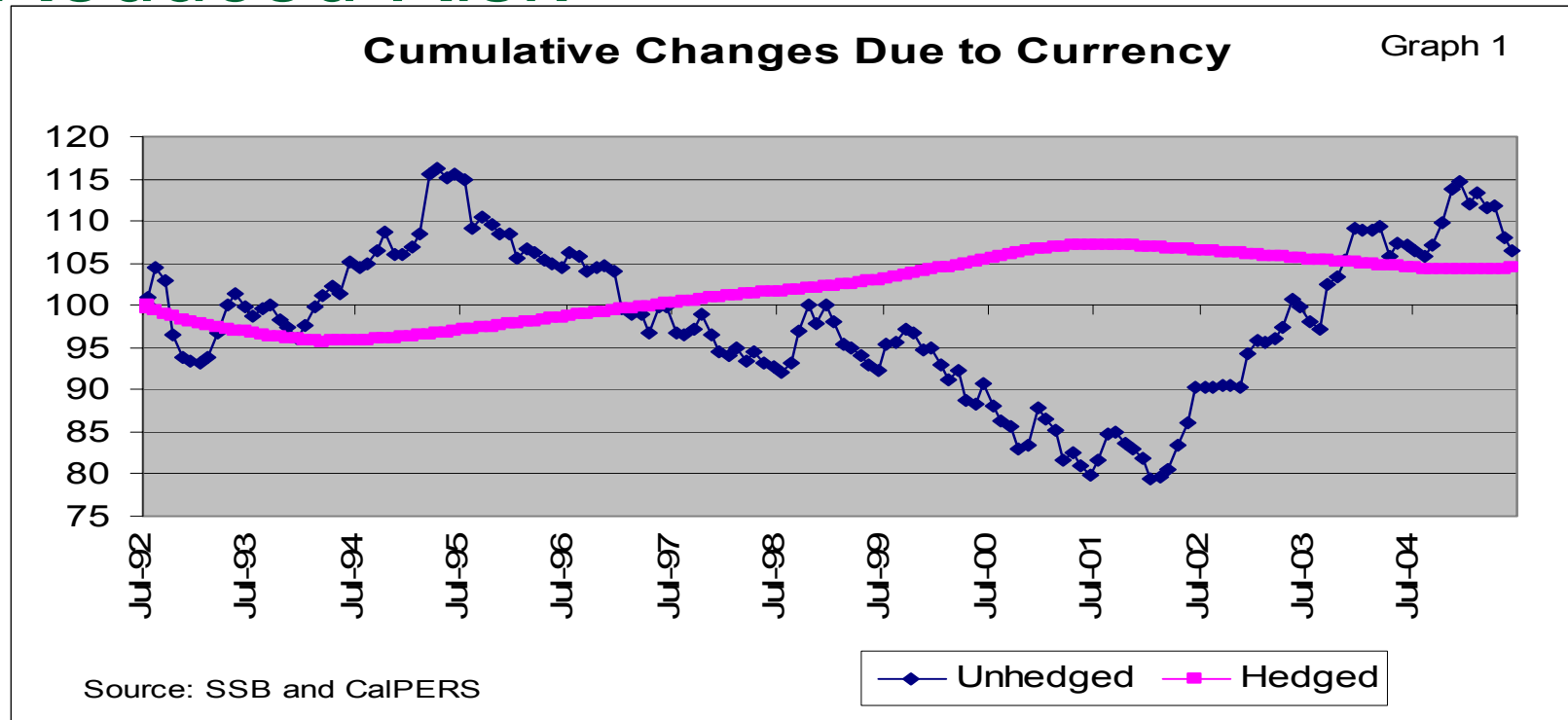
- Outline of plans
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CalPERS currency activities primarily emphasize risk reduction, as decided by the IC in 1991

Currency Overlay Program Consists of

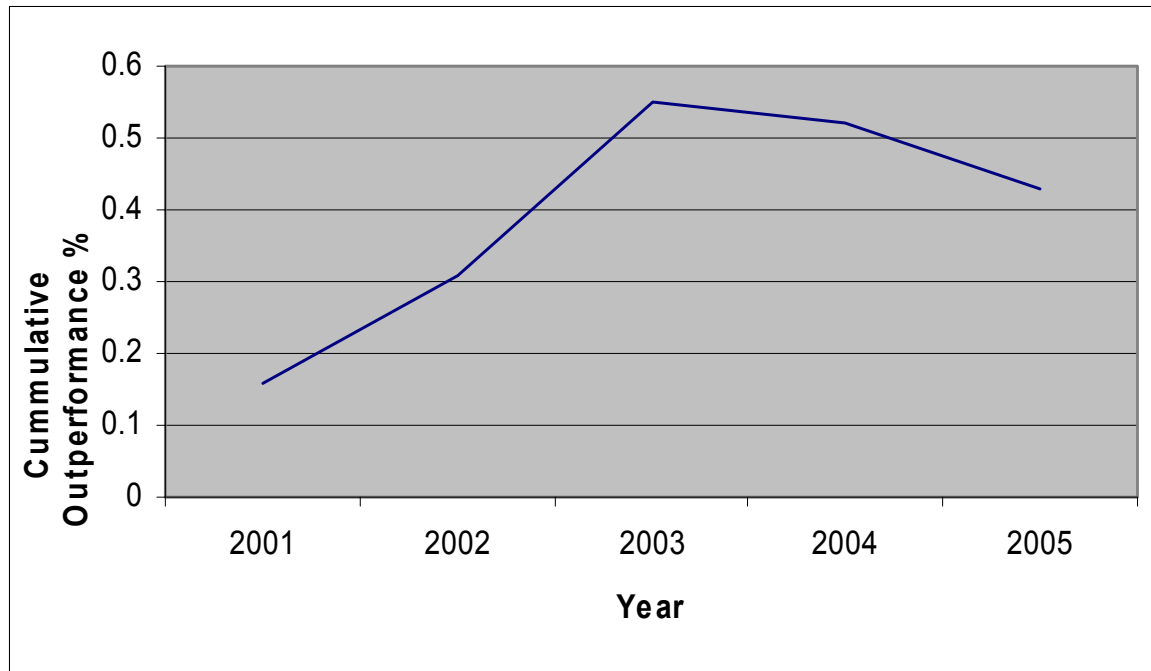
- Externally managed quasi-active portfolios
- Internally managed passive hedge portfolio (inception 2001)

CalPERS Total Currency Program Has Reduced Risk



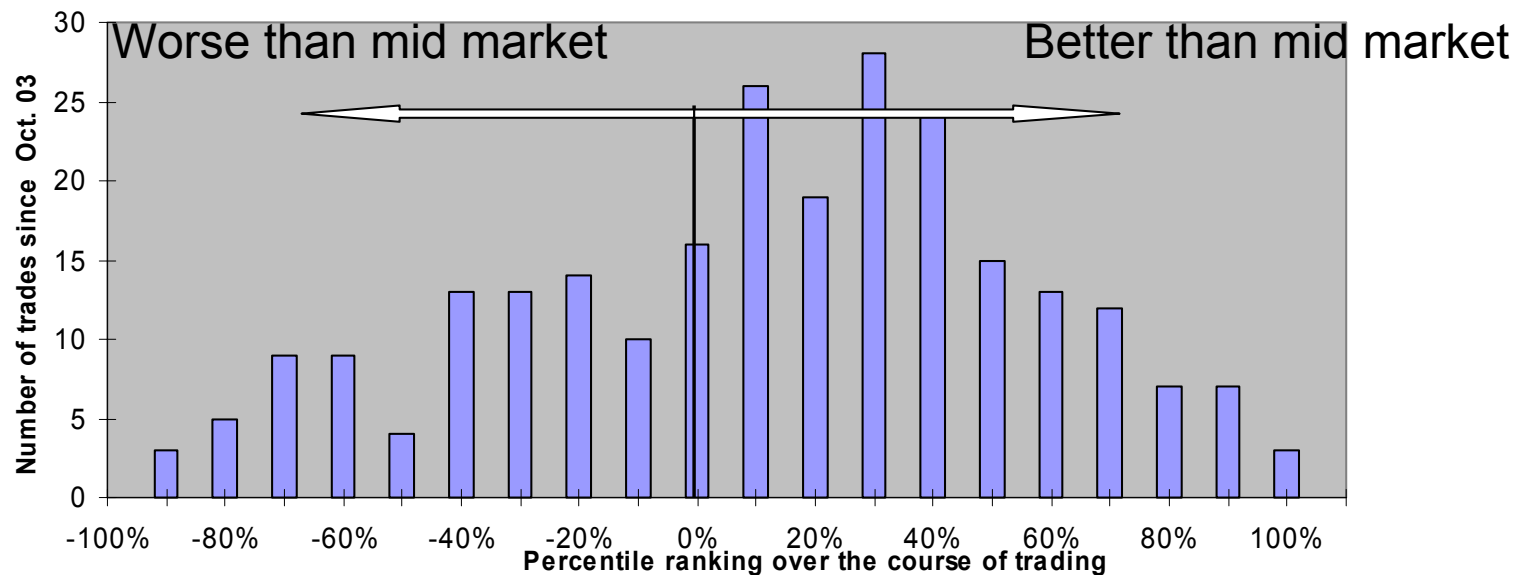
- The blue line is the unhedged currency return (i.e. no overlay)
- The pink line is CalPERS hedge benchmark portfolio
- Smoother is less volatile – 41 bps annualized since inception

Internally Managed Passive Portfolio has reduced risk; without the expected negative tracking error



Results: exceeded benchmark by 43 bps since inception

Internal execution of CalPERS currency needs. One would have expected a normal distribution...

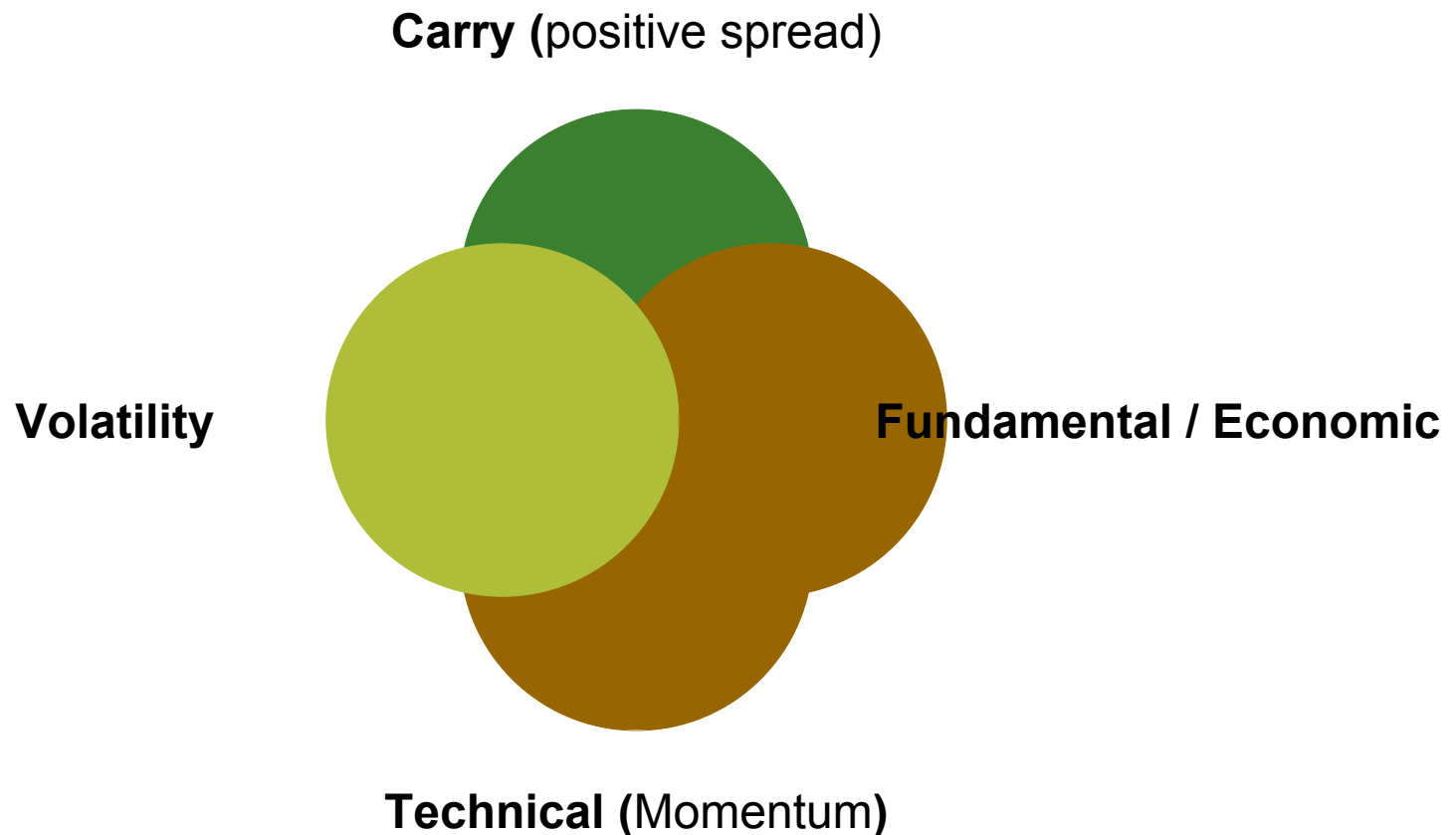


- CalPERS result is positively skewed with a saving of approximately \$4 million relative to previous alternative

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Active Currency Investment Styles



Currency Styles

- **Carry** – driven by spreads that exist on forward currency
- **Fundamental** – driven by measurable economic data
- **Technical** - driven by price changes, momentum
- **Volatility** – driven by the rate of change of prices

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Based on the 4 Currency Styles

- Forge and maintain strategic relationships with major players
- Develop internal quantitative models to suit each style
- Develop strategies for allocating capital to various styles
- Develop and maintain risk control measures and guidelines through Policy Subcommittee

We propose an addition of active currency program with emphasis on generating return

- Thus far the focus has been on risk reduction. We propose changing the focus to include RETURN, as well as risk reduction.
- Stand alone currency alpha program will start small and build only after positive results.
- This will utilize both internally and externally managed portfolios

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Next Steps

We plan to...

- Bring an agenda item to the IC for an internal active alpha program
- Subject to IC approval: Develop guidelines for active alpha to be approved by the Policy Subcommittee
- Plan an RFP for external active alpha managers

We are not...

- Changing existing programs
- Restricting any asset class from investing internationally, be it hedged or unhedged

2007 and beyond

- In 2007 at the Asset Allocation Workshop, consider currency at the total fund level
- Conduct an RFP for external active alpha managers

Conclusion

- CalPERS has had a successful currency program
- Existing programs should remain unchanged
- Staff is working toward an internal active currency alpha program
- Currency risk should be considered at the overall CalPERS portfolio level
- Conduct an RFP for external active alpha managers in 2007